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Supreme Court of the United States

OCTOBER TERM, 1938

No. 312

JOHN M. TAYLOR, OSCAR A. KENNEDY AND H. RUSSELL HASTINGS, AS THE INDEPENDENT COMMITTEE FOR THE PROTECTION OF THE HOLDERS OF PREFERRED STOCK OF DEEP ROCK OIL CORPORATION,

Petitioners,

vs.

STANDARD GAS AND ELECTRIC COMPANY, REORGANIZATION COMMITTEE OF DEEP ROCK OIL CORPORATION, H. N. GREIS, TRUSTEE OF DEEP ROCK OIL CORPORATION, AND DEEP ROCK OIL CORPORATION,

Respondents.

PETITIONERS' REPLY TO RESPONDENTS' BRIEFS

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PETITIONERS' REPLY TO RESPONDENTS' BRIEFS

I.

RESPONDENTS HAVE FAILED TO MEET THE BASIC ISSUE AS TO THE INVALIDITY OF THE STANDARD CLAIM AND THE IMPROPRIETY OF ITS COMPROMISE

Respondents have made no attempt to meet the basic issues raised in our petition and brief. In sweeping lan-

guage, they assert that our statement of facts is unfair and unsupported by the Record. However, except for a few sporadic instances hereinafter refuted, respondents make no attempt to point to any specific instances wherein our factual statement is either unfair or unsupported by the Record.

As we have shown, the uncontroverted facts in the instant Record disclose the fraudulent looting by Standard of its completely dominated subsidiary, the Debtor. *The Record of this case discloses a story of corporate thievery which, we submit, is unequalled in the reported decisions of this Court.* Nevertheless, the elimination of the public preferred shareholders is justified by respondents as a necessary part of the Debtor's reorganization on the ground that Standard has prior rights as a creditor of the Debtor to the extent of five million dollars, and that the appraisal adopted by the District Court leaves no equity for the preferred shareholders. *The principal issues in this case thus revolve about the invalidity of the Standard claim and the unfairness of the appraisal adopted by the District Court. Both of these two principal issues have been entirely avoided by respondents without any serious attempt to reply to our petition and brief.*

With respect to the Standard claim, we have shown that it is based on an open account between Standard and the Debtor, kept under the sole direction and control of Standard and reflecting only its own self-serving dictations throughout the period of its handling of the Debtor. We have shown that this open account includes many debit and credit charges and that it is only by reason of a claimed net debit balance that Standard bases its contention that it has a claim against the Debtor. That net debit balance, as we have shown, is entirely eliminated, when the fraudulent and unsustainable debit charges are re-

moved from that account. Moreover, we have shown that Standard's abusive handling of the Debtor and its securityholders requires the application of the Instrumentality Rule in the instant case to deny Standard's claim as a creditor and to relegate its net advancements, if any, to the position of a capital investment in the Debtor. On the basic issue of the invalidity of the Standard claim, as disclosed by the uncontroverted facts of this Record, respondents' briefs have made no attempt to answer the contentions we have raised and the facts and law in support of them which we have presented. Respondents' failure to point out any inaccuracies or impropriety in our charges with respect to the invalidity of the Standard claim should, we submit, be accepted by this Court as an acknowledgment that those charges are beyond refutation.

Respondents base their complete avoidance of these issues on their contention that the only issue before the Court is the question of the propriety of the District Court's exercise of its discretionary powers in approving the compromise. In taking that position before this Court, respondents are raising the same smoke screen that they have thus far successfully used both before the District Court and with the majority members of the Circuit Court of Appeals, in avoiding an inquiry into the real merits of the Standard claim.

To appreciate the insincerity of their position, it must be borne in mind that Standard's claim was allowed through a compromise mechanism solely at the behest of respondents and despite urgent objections by petitioners. The basic problem in the instant reorganization was, from the inception of the Debtor's receivership, the question of whether or not Standard had a valid claim as a creditor. Even the Chairman of the Respondent Reorganization Committee admitted this much when he said:

> "When I first got into this situation, I realized that the crux of the Deep Rock is the question of the validity of the Standard claim. It is correct that, depending upon whether or not Standard has a claim, depends the entire form and substance of any plan of reorganization that is to be submitted" (II-425).

Accordingly, the validity of the Standard claim was litigated in a trial on its merits which lasted over two and one-half years and which was finally completed when both sides rested their case on February 13, 1935 (II-1-376). The completed proofs in that trial disclosed that there was no substantial controversy over the facts and that the issue of the validity of the Standard claim was primarily a question of law. At that time, the completed trial on the merits presented for decision the single question of the validity of the Standard claim.

It was then that respondents sought to avoid a decision on the validity of the Standard claim by presenting the so-called first compromise proposal to allow Standard's claim at five million dollars (I-102-7). Respondents sought thereby to substitute the new issue of the exercise of discretionary powers in connection with a compromise, in place of the basic issue as to the validity of the Standard claim. This attempt to sidetrack this basic issue was defeated solely by the Taylors, predecessors of petitioners, when the court sustained their objections to the first compromise proposal (I-244-5). At that time, the Honorable District Judge stated in open court his opinion that the entire Standard claim was invalid and unsustainable by reason of the applicability of the Instrumentality Rule of Law (II-406-7).

Certainly by that time it was clear that any allowance of Standard's claim at a substantial amount through the medium of a compromise was entirely unwarranted and

could only be explained as an attempt to evade a decision on the basic issue of the invalidity of the Standard claim. Respondents, nevertheless, continued their determined effort to evade a decision on the merits of the Standard claim by again presenting a compromise proposal to allow that claim at the same figure of five million dollars (I-296, II-731-4). This second attempt proved successful, despite the best efforts of petitioners to secure an adjudication on the completed proofs on the merits of the Standard claim.

Respondents' chief justification for their insistence on a compromise of Standard's claim in lieu of an adjudication of the merits, is their contention that a compromise would end the litigation. The basic insincerity of that contention is shown by the admission by the Chairman of the Respondent Reorganization Committee that at the very time this second compromise proposal was submitted, he already knew that it would not end the litigation in view of petitioners' urgent objections (II-449-50). *Respondents thus knew, before submitting this compromise proposal, that it would not end the litigation.*

Respondents also knew that neither time nor expense could be saved by the compromise as against an adjudication on the merits of the Standard claim. The proofs on that claim had already been completed. It was then known that any appeal from an approval of the compromise would necessarily bring up the entire Record in the trial on the merits of the Standard claim. Respondents also knew that such an appeal would delay consummation of the reorganization just as much as an appeal from a decision on the merits. *Respondents thus knew, before submitting the compromise proposal, that they were saving neither time nor expense by compromising as against an adjudication on the merits of the Standard claim.*

The crowning infidelity of respondents' attempt to hide behind the issue of compromise lies in the significance of

the respondents' appraisal of the Debtor's assets at seventeen million dollars (I-358-61). In a reorganization of the Debtor, it is necessary to allocate some twelve million dollars for principal and interest to the noteholders, leaving only an equity of five million dollars as the stake of dispute between Standard and the public preferred shareholders. ***Standard procured that entire five million dollar equity in the Debtor's assets by the allowance of its claim at five million dollars. Thus Standard gained as complete a victory by the compromise as if its claim had been allowed in full.*** The compromise allowance of Standard's claim at that amount completely eliminated the preferred shareholders from any share in that equity. To give Standard the entire equity in the Debtor's assets, with practically nothing to the preferred shareholders, is actually no compromise at all. Yet respondents attach the label of compromise to this proposal in an effort to insulate themselves from an examination into the real issue as to the nature and validity of the Standard claim. Respondents seek here, as they did in the lower courts, to draw a veil of compromise as a barrier to this Court's examination into the merits of the Standard claim. To use the guise of compromise for the allowance of Standard's claim in the instant case, is to defile an honorable principle of business and public morality.

If, as we have contended, and as Circuit Judge Bratton found, the claim of Standard is invalid in its entirety, then no conceivable scope of discretion can warrant the compromise allowance of that claim at five million dollars. If the Standard claim is actually invalid, then to permit the compromise allowance in the instant case, must clearly be deemed an abuse of discretion. It is not true, as respondents would have us believe, that this Court will not set aside an abuse of discretion by the lower courts. This Court has, on many occasions done so.

Langnes v. Green, 282 U. S. 531, 75 L. Ed. 520 (1931);

Rogers v. Hill, 289 U. S. 582, 77 L. Ed. 1385 (1933);

Fairmount Glass Works v. Cub Fork Coal Co., 287 U. S. 474, 77 L. Ed. 439 (1933);

Meccano v. Wanamaker, 253 U. S. 136, 64 L. Ed. 822 (1920).

Moreover, Rule 38 of this Court expressly provides for this Court's exercise of its supervisory powers for that express purpose. *Langnes v. Green*, 282 U. S. 531, 542, 75 L. Ed. 520, 527 (1931).

When this Court undertakes to examine into the real merits of the Standard claim, it necessarily is presented with the important issues of law and questions of public interest which we have pointed out in our petition and brief. In examining into the nature and validity of the Standard claim and the propriety of its compromise, there is necessarily presented to this Court the questions of the applicability of the Instrumentality Rule, the presumption of fraud attaching to dealings between common directorates, fraudulent abuses prevalent among public utility holding companies as evidenced by Standard's handling of the Debtor, the abusive practices of dual capacity reorganization committees in putting through plans of reorganization for the benefit of the selfish interests of their creators and in complete disregard of their fiduciary responsibilities to public securityholders, and the various other issues raised by our petition and brief. These are the basic issues which, we submit, are inherent in the instant case. In urging that these issues should not be considered by this Court, respondents are raising the same smoke screen they have used throughout this litigation to hide the legitimate issues of this case, which disclose the actual invalidity of the entire Standard claim.

Although they completely avoid the issue of the actual invalidity of the Standard claim, respondents attempt to make oblique answers by a few disconnected and unsustainable factual contentions in support of the compromise. They urge for one thing, that the Trustee and his counsel have recommended the compromise proposal. If that contention were of any controlling significance in the instant case, the answer to it is clear and undeniable. In our petition, we quote from a statement made in open court by the Trustee and his counsel, that they neither recommended nor rejected the compromise proposal (Our Petition, p. 27). That statement by the Trustee and his counsel was made during the course of the trial before the District Court, to prevent petitioners' attempted cross-examination of the Trustee on the basis and fairness of the compromise proposal (II-523-4). Based on that statement, petitioners were denied the right to cross-examine the Trustee with reference to the propriety or impropriety of making the compromise (II-523). After the close of all of the proofs, the Trustee's counsel in the course of his argument took the position for the first time that he recommended the compromise (II-561). At that time, there was no longer any opportunity to cross-examine the Trustee as to the basis or fairness of the compromise proposal. We submit that no weight should be given to the recommendation of the Trustee's counsel made under such circumstances.

In further support of the compromise, respondents assert that the compromise amount only includes items of valid advancements made by Standard for which Standard is entitled to a claim under the decision of *Southern Pacific Co. v. Bogert,* 250 U. S. 453, 63 L. Ed. 1099. In answer, we desire to point out to this Court that there is not a single word of evidence in the instant Record as to

what items were taken into account in allowing to Standard a claim for five million dollars. The Trustee refused to be examined on that point (II-521-4). The Chairman of the Respondent Reorganization Committee admitted, under cross-examination, that he did not know what items were considered in arriving at the compromise figure (II-451). Standard offered no proofs whatsoever in explanation of the compromise. *Respondents' assertion that the compromise allowance contains only undisputed items is thus unsupported by a single word of testimony in the instant Record.*

As a further answer to this contention of respondents, we have shown in the course of our petition and brief, that an elimination of the actually fraudulent and unsustainable charges included in the Standard account would leave the debit side of the open account in an amount far less than the amount of the credits which appear in the same account. Thus, even assuming that there are many valid items of advancements contained in the debit side of the open account, Standard has no valid claim whatsoever. Moreover, as we have shown, the application of the Instrumentality Rule of law to the instant situation likewise requires denial of Standard's entire claim as a creditor relegating Standard's claim for net valid advancements, if any, to the position of a capital investment in the Debtor. No such issues are presented by the *Bogert* case.

In keeping with respondents' efforts to raise dust clouds for the purpose of avoiding the real issues in this case, counsel for the Trustee present the argument that a setting aside of the Refining Company transactions requires reversal of certain credits which Standard had caused to be entered on the Deep Rock open account in the latter part of 1925 (Trustee's Brief, pp. 4-5). Counsel for the Trustee attempt to use that fact standing by itself

and apart from the other facts and issues of the instant case in justification of the propriety of the compromise. Such an attempt is patently unfair. There is no doubt that the setting aside of the Refining Company transactions requires the reversal of these credit entries and increases the debit balance on the open account by some two and one-half million dollars. The answer is clear, however, that the elimination of the fraudulent and unsustainable items from the open account wipes out the adjusted debit balance just as completely as the claimed debit balance. Moreover, the Instrumentality Rule is as equally applicable to the adjusted debit balance as it is to the claimed one.

Respondents' evasion before this Court of the basic issue of the invalidity of the Standard claim, merely accentuates the history of their conduct throughout the instant case. They seek to side-track this Court as they side-tracked the lower courts from an examination into the true merits of the Standard claim. We submit that this Court should look behind the smoke screen respondents have raised and examine into the basic issue of the validity of the Standard claim, and in the light of such an examination, pass upon the question of the propriety of its compromise. Such an examination, we submit, will present for adjudication to this Court the very important issues of law and public interest which are presented in our petition and brief.

II.

RESPONDENTS HAVE FAILED TO MEET THE BASIC ISSUE AS TO THE INVALIDITY OF THE APPRAISAL ADOPTED BY THE DISTRICT COURT

To the basic issue of the legal insufficiency and unfairness of the appraisal of the Debtor's assets as adopted by the District Court, respondents' only answer is that that presents a fact issue upon which this Court cannot pass. In reply, we desire to again point out to this Court that the invalidity of that appraisal is not based upon any disputed issues of fact. As we have shown, that appraisal admittedly gave no consideration to the earning power of the Debtor as a going-concern. That was admitted and recognized as a basic defect in the appraisal by the sole expert witness produced by proponents in support of the appraisal, by the Trustee of the Debtor, and by the District Judge, himself (II-504, 528-9, 566). Such an appraisal, as we have shown, is legally unsustainable. The approval of such an appraisal cannot be condoned as an exercise of discretion by the District Judge.

As we have shown in our petition and brief, the appraisal adopted by the District Court is utterly unfair. It was by far the lowest appraisal ever made of the Debtor's assets. It was far lower than the Trustee's own former appraisal made since receivership of the Debtor. It completely and admittedly omitted any consideration of the Debtor's earnings, although the Debtor had made substantial earnings throughout its existence and since receivership. Although designated as the Trustee's appraisal, it was actually prepared by employes hired by Standard and under sole allegiance to Standard.

As we have further shown, a fair appraisal in the instant case is of fundamental importance to the rights of

the preferred shareholders. A fair appraisal would result in a large enough value for the Debtor's assets to provide full payment to the noteholders and Standard, even assuming Standard has a valid five million dollar claim, and still leave enough of an equity in the Debtor's assets to give the preferred shareholders a substantial participation instead of their practical elimination resulting from the appraisal and plan approved by the District Court.

Here, again, respondents avoid the basic issue thus presented, and raise, instead, the smoke screen argument that the approval of the appraisal constitutes a finding of fact which this Court cannot review. *The answer is clear that this Court has, in the past, granted certiorari to set aside a lower court's approval of an invalid appraisal and to require a competent, fair and legally sufficient appraisal.*

National Surety Co. v. Coriell, 289 U. S. 426, 77 L. Ed. 1300 (1933);

First National Bank v. Flershem, 290 U. S. 504, 523, 78 L. Ed. 465, 477 (1934).

We submit that the Court should do likewise in the instant case.

CONCLUSION

There is no dispute but that under the instant compromise and plan of reorganization, the public preferred shareholders of Deep Rock are practically eliminated from their five million dollar investment. This elimination is for the sole benefit of Standard, the parent company, which has throughout been in complete control of the Debtor, looted its assets, sold its securities to the public under misrepresentations and manipulations of value, and now seeks to take the last remaining equity from these same public securityholders by the instant compromise and plan of reorganization. It must be clear that such an elimination of public shareholders should not be countenanced by this Court in the absence of a clear showing that it is legally justifiable and inevitable. This Court should not sanction the deprivation of this large investment of these public shareholders, without at least an investigation into the true merits of the instant case.

On the two basic issues of the instant case, the invalidity of the Standard claim and the unfairness of the appraisal, respondents have made no attempt to answer our contentions. Instead, they have sought to evade these issues by smoke screen arguments. We submit that, looking through the forms and into the substance, the real issues involved in this case require an examination into the true nature of the Standard claim and the question of its actual validity or invalidity. This basic issue involves problems of grave importance, not only to the public preferred shareholders in the instant case, but to public shareholders throughout the country.

Furthermore, the unfair methods by which it is sought to eliminate the public preferred shareholders in the instant case are, we submit, sufficiently common to make a

decision condemning those methods one of great public significance. The matter of dealings between inter-related corporations, the abusive practices of public utility holding companies, the derelictions of dual capacity reorganization committees, the manipulations of appraisals and valuations for the benefit of interested parties, the basic problem of the susceptibility of 77-B proceedings to abuses against minority interests—all of these are problems of wide interest to public securityholders throughout the country. These problems and issues, inherent in the instant case, are sought to be hidden by the veil of evasions respondents have raised. We respectfully ask this Court to pierce through that veil and consider the basic issues which this case presents.

We respectfully submit that the petition for certiorari should be granted in the instant case.

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